THE FINANCIAL SYSTEM IN INDIA

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So far, Japan's interest in the Indian economy has been centred on economic development programmes and foreign trade, and there has been little comprehensive research on their financial system. The joint research project on India's financial structure conducted recently by five researchers under the sponsorship of the Institute of Asian Economic Affairs is the first undertaking of any magnitude on this problem.

The word "financial system" bears various meanings, both broad and restrictive. This research project did not confine itself to finance in a narrow sense, i.e., the structure of capital circulation or to financial institutions. Rather, the emphasis was placed on clarifying the entire structure of industrial and financial circulation of funds in India. As there is a scarcity of original data available, the preparation by the researchers was, of necessity, restricted. Accordingly, this report is, in some cases, an introduction or summary of the data on India, while some portions constitute an experimental type of report not based on extensive research. Therefore, the connection and coordiantion between chapters are not claimed to be perfect; yet, this report is without doubt an important introduction to research on this type of problem in our country.

The theme for this joint research report could also be entitled "The source of funds for economic development and the structure of funds demand and supply." At present, the funds for economic development of India are mainly acquired from three sources: 1) tax revenue; 2) domestic loans, and 3) foreign loans. These three sources will be discussed in the following chapters: tax revenue in chapter one "Structure of Public Finance and Capital Formation"; domestic loans in chapter two "Financial Institution"; and foreign loans in chapter five "Foreign Investments." The structure of money demand and supply will be examined closely in chapter two and chapter three "Agricultural Financing" and chapter four "Foreign Exchange Banks." Especially in chapter four the histories and the present conditions of the leading domestic and foreign banks now in operation in India have been thoroughly discussed. Next, the contents of the various chapters will be reviewed.

Chapter I. Public Finance and Capital Formation

As is the case with almost every country, the role of the Government in the economic development of India, and in consequence, the role of public finance, especially of tax revenue has substantially increased in recent years.

India, which has been carrying out five-year plans for over ten years, is suffering from the inadequacy of domestic funds available for public development projects, and is now the world's largest recipient of foreign aid. The ratio of tax revenue to national income for the past several decades has been about 7 per cent, the lowest ratio in the world. Therefore, two of the most urgent problems for India are: 1) to enlarge the source of funds for public investments through a tax reform and the collection of additional taxes; and 2) to rectify the inequity of wealth, income, and tax distribution which prevails in India today. From this viewpoint, Chapter I makes an inquiry into the present conditions of public finance and investments in India, centreing on the problem of tax reform.

The two big movements towards tax reform were the Taxation Enquiry Commission in 1953 and the proposed tax reform by Nicholas Kaldor. From the standpoint of social justice, the Indian Government took the policy of increasing direct taxes and decreasing indirect taxes, while, contrary to their intention, the direct taxes had to be decreased in order to promote the investment activities of the private enterprises. But, in 1951, they reverted to the easier method of relying on indirect taxes to raise funds for the First Five-Year Plan.

The Taxation Enquiry Commission was given the task of drafting a tax reform bill, having the objectives of both rectifying the aforementioned inequities and raising funds for development. Of course, the stress was on the latter, and the Commission came to the conclusion that various present indirect taxes, especially, the Federal excise duties and sales taxes should be extended to lower income brackets in order to raise needed funds for public investments, even if it would necessarily restrain consumption by the public.

The increase of revenue by this scheme, however, was far short of the amount required for the Second Five-Year Plan. Besides, the effects of a positive tax reform could not be obtained thereby. Because, the general consumption level was very low it could not be lowered anymore. Tax-collection, in cash, was difficult in itself. And the poor tax collecting techniques permitted tax evasion. Thus, it became necessary to seek additional revenue sources which had escaped the recommendation of the Enquiry Commission, and Mr. Kaldor was engaged by the Indian Government to draft another reform plan.

The tax reform plan set up by Kaldor was aimed at overall revision of the direct taxation system, whereas the objective of the Taxation Enquiry Commission had been to increase indirect tax revenues. He, Kaldor, believed that the direct taxation system in India was very unjust and ineffective; that enough funds for the five-year plan could be derived from effective taxation on the minority of the wealthy class. The main point of Kaldor's reform plan was, besides a revision of the present income tax, to create anew a Tax on Wealth, a Capital Gains Tax, a General Gift Tax, and an Expenditure Tax, and to levy these taxes at the same time the Comprehensive Return was to be filed to prevent tax evasion. By establishing the maximum tax rate by various taxes, he tried to hold down the interfering infleunces of taxation on the economic development.

The Kaldor proposal was put into effect during the 1957-1958 fiscal year.

But, his plan was only partially implemented, and the anticipated results were never realized. Therefore, most of the burden of the supplementary tax was imposed on the residents of the urban areas. And the tax revenue potential of the rural areas has still to be developed. Moreover, preventive measures for tax evasion seem to be inadequate. The public investment, the bulk of which is created by increased taxes, has, in spite of the aforementioned difficulties, increased considerably in recent years. It has expanded five times its original size, while private investments expanded less than two times. Correspondingly, India's traditional dormant tax structure has finally begun to change. This is not true in all cases; for the latent tax source (pre-modern and feudalistic income) has not yet been grasped——a fact that is gradually commanding the strong attention of intellectuals.

Chapter II. Banking Institutions

Chapter II gives a general despription of the financial institutions of India, classifying them into six parts; and attention is directed especially to the efficiency of their activities. The coexistence of native banking facilities or the bazaar markets and modern banking facilities without any close relationship between the two is the main characteristic of the financial structure of India. An excerpt from the Report follows, defining each group of financial institutions.

1. The native banking facilities comprise indigenous bankers in one group and money lenders in another. The main differences are that the indigenous bankers conduct business accepting deposits and negotiating *hundis*[1] cheques, dealing primarily in commercial loans; while the money lenders deal more in rural consumer loans. The rates of interest on loans made by the latter are by far higher than those charged by the former. They have one thing in common. Both banking facilities are unorganized hereditary family trades based on the caste system. The native banking facilities handle most of the conutry's financial business.

2. Private commercial banks in India consist of 400 joint stock banks established under the Banking Companies Act of 1949. Of this number there are less than 80 comparatively larger banks and 16 or 17 foreign banks which constitute the so-called scheduled (designated) banks. To examine the conditions of the assets and liabilities of the joint stock banks, we notice that the percentage ratio of fixed deposits to liabilities on deposits has made a rapid increase in recent years. This will naturally increase the depsoit cost, and it may be a problem that long and short term loans have not increased to date. Banking companies in India have traditionally carried on short-term commercial loans as a main function. But, India suffers from the shortage of long-term development funds. It is hoped that the present poor connection between industry and the banks is quickly remedied, and the desperately needed long-term loans will be forthcoming.

3. Among the corporate banks, the State Bank of India, the former Im-

[1] '*darshani*' *hundi*——a demand draft.

perial Bank of India, operates on an extraordinarily large scale. It is a government bank established by the special law. Besides routine commercial banking business, it is specifically charged with financing medium and small enterprises and the remittance of the government's foreign exchange.

4. The Co-operative Banks and the Land Mortgage Banks are agricultural financing organizations under the cooperative union system established 50–60 years ago. The former, Co-operative Banks, made short-term loans and the latter long-term loans. The description of the structure of these banks has been omitted, but it is well to note that loans to farmers by the Co-operative Banks account for only about 3 per cent of the agricultural finance. It is clear from this that the Co-operative Banks cannot compete with the financial strength of the farm money lenders.

5. Recently, semi-governmental or government-owned industrial finance institutions have been established as the ordinary banks lack the capability to supply long-term industrial funds. The following six corporations have been established to supply these funds: 1) Industrial Finance Corporation of India; 2) State Financial Corporations; 3) National Industrial Development Corporation; 4) Industrial Credit and Investment Corporation of India; 5) Refinance Corporation for Industry; and 6) National Small Industries Corporation. Many of these have been established by funds received through foreign aid and none of these banks have yet started full operation.

6. As for Reserve Bank of India, which is the national central bank, the Report describes in detail its organization, duties, functions, etc., referring to the Reserve Bank of India Act and other sources. It is noted that the assets to back the issuance of bank notes are mostly the rupee certificate (the Finance Ministry's notes having the character of "red ink" bonds) with very little gold or foreign reserve funds. While, on the other hand, the supply of funds to the banking facilities for loans are limited. Such a formula for supplying currency can be said to be effective for India's economic development, centred on the public sector, but, at the same time it is not in line with sound currency and accepted banking practices.

Summing up the figures of all the various financial institutions, the total of bank deposits in India is only 20–30 per cent of the total currency. Therefore, it can be said that financial policy by the Government or the central bank does not have much influence on India's economy, nor do the interest rates accurately reflect the economic activities. The fixed deposits have recently surpassed the demand deposits in the scheduled banks and the gap is increasing. The banks also maintain a high reserve rate of cash. These are the indicators, which relate the soundness of the bank administration to the financial market. However, they only denote the soundness of the financial market itself and cannot be considered proof that India's financial institutions are participating effectively as financial mediators in the overall economy. All the financial institutions in India cannot be said to be contributing effectively to the economic development of India especially in the long-term industrial investments.

Chapter III. Agricultural Finance

One chapter has been devoted to the financial problems of agriculture, the largest industry in India (70% of the total population; 50% of gross national production). The actual conditions of agricultural finances in India have not been grasped in detail even by Indian researchers. The actual conditions of agricultural financing are explained, in the report, based mainly on the 1955 Report of the Reserve Bank of India, "All-India Rural Credit Survey", which is the only comprehensive research data concerning this problem. It is fitting to say, however, that the Report deals more with problems of rural financing or farm debts than with agricultural financing.

The total loans by all the farmers in India is about 7,500,000,000 rupees annually and the amount outstanding is believed to be several times more. It is estimated that the average annual loan is 160 rupees per rural family; and 309 rupees per borrowing family. The average amount of funds loaned to the farmer varies from 1 to 10 times depending upon the state. Loans also vary with the size of the family's farming operation; that is, the larger the scale, the large the loan.

Of the money borrowed by the farmer about 50 per cent is for family consumption, and then 28 per cent is for capital expenditure and 9 per cent normal farm operation. This is more a debt on farmers than agricultural finance, reflecting the true feature of Indian agriculture. By examining the sources of these funds this situation will be made more clear. About 76 per cent of the loans to the cultivators are made by professional or side-business (including landowners and mer-chants) lenders; 14 per cent is borrowed from relatives; and loans from the governments, cooperative associations and commercial banks are 3.3 per cent, 3.1 per cent and 0.9 per cent respectively; with 92 per cent of the loans being "pre-modern loans." In order to crack down on these evil practices and the expolitation of farmers by farm-loan sharks, various legislative measures have already been introduced in the last century and special laws have been established by the various states, to control these activities, but the situation has not improved.

On the other hand, the banking institutions that are concerned with agricultural finance are, as mentioned in the separate chapter, the Co-operative Bank, the Land Mortgage Bank and the Reserve Bank of India. All of them have been making efforts for many years to improve the financial position of rural communities. However, this type of agricultural financing having the character of mutual aid or, the relief of farmers to promote agriculture is too weak to exercise its influence on rural communities under the established pre-modern system. Of course, the savings of a minority group in the rural area is by no means small, but as capital most of it flows to the cities and foreign countries, and in present circumstances it is impossible to channel these funds into direct agricultural investments.

Chapter IV. Exchange Banks

Among the banks that are operating in India, the comparatively large corporate banks of India and the branches of foreign banks which, in all, number about 90 are called scheduled banks.

In India, the "foreign exchange bank" or "exchange bank" often means a bank of foreign nationality, but in this chapter, the terms will be used to denote banks doing foreign exchange business. That is, in this chapter, the foreign trade financing problem will be taken up as follows: (1) the development of the exchange banks since the era of the East India Company in the 17th century; (2) clarification of the foreign trade financial structure, comparing the bussiness and financial strength of foreign banks with that of Indian banks; and (3) the history and the present conditions of each exchange bank is described. This chapter is not confined to foreign trade financing as such, but provides a concrete survey of the principal domestic and foreign banks in India.

Let us next outline the contents of the Report centreing on item above 2. India was a British colony for the past two hundred years, so in the early stage of its colonial rule the advance of foreign banks into the Indian economy denoted the development of British colonial banks. But, in the 19th century, European, American, Japanese, and other various countries established exchange banks and joined in the competition. Today, besides eight English banks, nine banks from America, Japan, Pakistan, Holland, France, and China make a total of 77 foreign banks conducting business in India.

During the period when these foreign banks were being established and developed, Indian banks, with little funds and ill-prepared for international finance, were unable to enter the foreign exchange market. Because of the *Swadeshi* movement, since the beginning of the 20th century and through World War I, banks operated by Indians have enjoyed remarkable success. But the foreign exchange business was not freed from the monopoly by the foreign banks and the British Indian Government, until after the independence of India in 1947. At present, 20 Indian banks are dealing in foreign exchange including the 9 large scheduled banks.

When compared with the foreign banks, these Indian exchange banks are much weaker in respect of capital, and accordingly, the foreign trade financing is still largely dependent upon the foreign banks. In recent years, however, the advantages enjoyed by the foreign banks are gradually disappearing and as a result, an epochal situation has been created. The total volume of foreign exchange business conducted by the foreign banks is less than that of the Indian exchange banks. This is due to the following reasons; the recent shortage of of funds in the foreign banks (diminishing increase rate of deposits), the decline in the volume of trade handled by the foreign firms, and the policy of the Indian government to promote home banks (custoday of public funds and favourable tax treatment).

However, in respect to the volume of business, the foreign banks are 5 to 10 times larger than the Indian bank, indicating that the advantageous position of the foreign banks is still intact. It is to be noted however that the relative positions of foreign banks in India among themselves has been shifting recently. That is, the position of English banks has declined, while the American banks are enjoying a business upswing and a rapid increase in profits.

The Report also describes in detail the business and the earning positions of various important foreign banks and Indian banks. It examines the basis of the operations of the exchange bank, that is, the investment in India by various foreign countries. And it delves into the trade situation handled by the domestic and foreign firms. Although the self-reliant growth of capital and enterprise of India is now an acknowledged matter of record, the aid and investments by various foreign countries are acting as an outside pressure in a new form. This may suggest that the real economic independence of India is still far in the future.

Chapter V. Foreign Investments

In the last chapter, the loans and investments to India by foreign countries for both public and private sectors will be taken up. Like public finance, dealt with in Chapter I foreign capital is not a financial problem in itself, but the problem of its presence cannot be ignored, as it forms an important source of India's development funds.

The investigation of foreign investment in India is too complex a task to be undertaken by individuals or small institutions. But fortunately, in India, the Reserve Bank of India makes it an annual task to evaluate India's international investment position. And it has already published in report form the results of the three large-scale special surveys and annual surveys conducted to date. In this chapter, the contents of the Reports by the Reserve Bank of India are first of all introduced and then analyzed in detail.

According to the report, the overall international investment position of India grew worse in the 12 years (1948–60) covered by the surveys. From a credit balance of 15 billion rupee reserves dwindled to a debit balance of 9 billion rupees. This was due primarily to the Second Five-Year Plan in which the expansion of public investments reduced the foreign reserve and increased foreign loans. At present 70 per cent of the debts in the public sector is loans from America and the World Bank. Other major creditor countries are England, West Germany, and the USSR. The cumulative total of loans authorized up to the present amounts to 20 thousand million rupees, over half of which still remained unutilized at the end of the Second Five-Year Plan. Of the 7 thousand million rupees of private foreign investment in India, over 80 per cent is "foreign business investments." The Reserve Bank of India's survey reveals each year the distribution of investments by industry and by the form of investment, England supplies 70–80 per cent of the total investments, holding almost a monopolistic position, but, of late, the investments by America and the World Bank are gradually increasing.

Seen industry wise, the three largest fields of investments are the manufacturing industry, the oil industry, and the plantations which combined is close to 80 per cent of the total investments. As for the form of investments, direct investment in foreign companies and foreign-controlled Indian joint-stock companies accounts for 80 per cent; while the share of portfolio investments is very small. As to the proceeds of the foreign investments, the profits, or dividends on foreign capital in the private sector reached 3 to 4 times that of the proceeds from interest on foreign capital in the public sector. The private investments by America and England has the highest rate of return and capital gain is higher in India than in those countries.

The aforementioned is a general outline of the survey data released by the Reserve Bank. This chapter further attempts to estimate what position and how much influence foreign investments have on the Indian economy. In viewing the economic structure of India from the standpoint of national income by industries, the pre-modern fields are overwhelmingly large, as the modern or capitalistic private enterprise fields employ only 3.7 per cent of the working population and contribute only 11.6 per cent of the total income. Three elements constitute this small progressive economic group. They are Government enterprise, Indian capital enterprise and foreign capital enterprise. But, these three are very important in that they comprise the core of the Indian economy.

Let us refer to the foreign capital aid in the public sector. India's increasing dependence upon foreign aid to support her economic development plans is fast approaching the critical point. To cope with this situation, a planned programme coordinating domestic savings, domestic investments and foreign funds is required. Above all, a more effective mobilization of the latent, private sources of funds by the government is being strongly requested inside and outside India. This is a very difficult task for the Indian Government.

In order to clarify the importance and influence of foreign capital in the private corporate sector as compared with the holdings of native Indian capital, the following data is set forth: The foreign capital invested in India amounts to 25.8 per cent of the net worth (owned capital) of all corporate enterprises in India. Its share in the total combined assets including outside capital is only 17.6 per cent, but it controls as much as 36.8 per cent of total corporate assets. The percentage share of foreign capital to profits after tax is 32.3 per cent, and in retained profits or reinvested profits it stands at 30.9 per cent. In the light of these figures, it can be said that the foreign capital invested in the private sector should not be considered a mere investment, but rather the means by which a strong foothold in the management of enterprises and in the control of the native capital has been established. Foreign captal is thus conducting bussiness in a more favourable climate than India's capital. The profits earning rates of foreign and Indian capital in the latest several years are estimated at 8.81 per cent and 6.66 per cent respectively.

From the aforementioned report, it can safely be said that as a result of the economic development, the problem of foreign capital in India's economic development finance is assuming a growing importance. This is a kind of self-contradication for the Indian economy, and to solve this problem the tax reform as set forth in Chapter I, and changes in the financial institutions to increase their efficiency, are most urgently needed. This is of course not a problem of financial techniques but is a problem directly connected with the political, economic, social reform and development of the entire Indian nation.

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